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Regaining the Banks' Flight Control Monitors to Navigate the COVID-19 Storm

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I only spent six years within a community bank, but considering when those years fell (i.e., from April 2008 to June 2014, during the thick of the Great Recession), I learned an awful lot about credit risk management, even though I was only incidentally involved in the credit management function as a member of the management loan committee and the board of directors. During that time, I learned a very important principle of credit risk management: never extend periodic loan payments indefinitely because it impairs the bank's ability to monitor the credit health of the borrower. I learned quickly that trying to manage a credit portfolio without having such critical information as the borrower's history of making loan payments in accordance with the original terms of the loan was like trying to fly a plane through a storm without the critical monitors located on its flight control panel. Because I learned these lessons, my initial reaction to the response that banking regulators and Congress had to the potential credit problems posed by COVID-19 pandemic was one of confusion.

A brief review of the history of this response begins with Financial Institution Letter (FIL) 17-2020, issued by the Federal Deposit Insurance Corporation (FDIC) on March 13, 2020, the same day President Trump declared a national emergency because of COVID-19. In FIL-17-2020, the FDIC encouraged banks to work with customers and communities affected by COVID-19 "in a prudent manner," without giving much detail as to what would be considered "prudent." The FDIC went on to say that a bank's prudent efforts to modify the terms of existing loans for affected customers would not be subject to examiner criticism.

Five days later, on March 19, the FDIC issued Frequently Asked Questions(FAQs) for both banks and customers to address loan modifications, including whether or not such modifications would be considered Troubled Debt Restructurings (TDRs) under current Generally Accepted Accounting Principles (GAAP). This topic is a significant one for banks since many worried that offering prudent accommodations such as those addressed by FIL-17-2020 could lead to those loans being classified as TDRs, which often leads to a loan being considered impaired, classified, or possibly placed on nonaccrual status if the loan is not well secured. In its March 19 FAQs, the FDIC clarified, for those banks pursuing the "prudent" accommodations encouraged by the FDIC's FIL-17-2020, that "a restructuring of debt constitutes a TDR [under GAAP] if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider." The same day the FAQs were issued, FDIC Chairman Jelena McWilliams sent a letter to the Financial Accounting Standards Board (FASB) that urged it to exclude

COVID-19-related modifications from being considered a concession that could lead to the loan being treated as a TDR.

Just three days after that, on March 22, all federal banking regulators, including the FDIC, the Federal Reserve Board of Governors (FRB), and the Office of the Comptroller of the Currency (OCC), along with the Conference of State Bank Supervisors (CSBS), issued an interagency statement to report FASB's confirmation that "short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not TDRs." The statement cited six-month payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment "that are insignificant" as examples of short-term modifications. The statement also said that factors a bank should consider in making such a determination of significance include whether the amount of delayed payments is insignificant relative to the unpaid principal or collateral value of the debt, and whether the delay in timing of the restructure payment period is insignificant relative to the frequency of payments under the debt, the debt's original maturity, or the debt's original expected duration. Finally, the March 22 interagency statement added that borrowers would be considered "current" if they were less than 30 days past due on the contractual payments "at the time a modification program is implemented."

Then, on March 27, Congress attempted to clarify the issue further through Section 4013 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Under Section 4013, financial institutions are permitted to suspend, for loan modifications related to the COVID-19 pandemic, requirements otherwise applicable under GAAP that require banks to categorize loan modifications as TDRs. Section 4013 states that a TDR designation is not required if the loan modification is made (i) in the period from March 1, 2020, through the date that is the earlier of 60 days after the end of the COVID-19 national emergency or December 31, 2020; and (ii) to loans that were not more than 30 days past due on December 31, 2019. This relief appeared broader than what was previously provided by the interagency statement because it imposed fewer restrictions on the bank's ability to modify loan terms without having to treat the loan as a TDR, and it required the principal federal banking regulator to defer to the bank's determination to suspend TDR classification for COVID-19-related loan modifications. As a result, banks believed that they were being encouraged to do exactly what traditional credit risk management canon discouraged: grant payment deferrals for up to nine months to customers who were already facing credit difficulties. However, subsection (d) of Section 4013 of the CARES Act did provide that when banks suspend TDR treatment for modified loans, they "should continue to maintain records of the volume of loans involved," and the banking regulatory agencies "may collect data about such loans for supervisory purposes."

Following up on this legislation, the federal and state bank regulatory agencies issued another interagency statement on April 7, which required banks to maintain records of loans modified under Section 4013 that may be collected for supervisory purposes, and reiterated that modified loans not covered by Section 4013 would be evaluated in accordance with the March 22 interagency statement. However, the April 7 interagency statement also provided that modified loans should generally not be reported as past due, nonaccrual, or charged off unless more information became available that indicateed a specific loan would not be repaid.

For the next four months, banks were mostly under the impression that both Congress and their federal and state bank regulators desired for them to do all they could to grant payment deferrals to borrowers adversely affected by COVID-19, so long as those borrowers kept accurate records of the deferrals granted and possibly took moderately more prudent steps, such as amending their loan policies and procedures to allow for these "low maintenance" modifications.

Then came another joint statement, which reflected the type of evolving guidance that banks have become all too familiar with during this pandemic (e.g. the Paycheck Protection Program and its implementing regulations and guidance). The Federal Financial Institutions Examination Council ("FFIEC") issued its "Joint Statement on Additional Loan Accommodations Related to COVID-19" on August 3, 2020, "to provide prudent risk management and consumer protection principles for financial institutions to consider while working with borrowers as loans near the end of initial loan accommodation periods" applicable during the COVID-19 emergency. Apparently, as the world realized that the pandemic and its resulting economic effects would last much longer than a few months, and as the banking regulators recognized that many of the initial loan deferrals would soon be ending, the FFIEC remembered the core tenets of credit risk management that we all learned so well 10 years ago: deferring credit problems without more in-depth analysis merely hides, and possibly multiplies, asset quality problems.

This realization was stated explicitly in the August 3 joint statement when the FFIEC said that its "members recognize that some financial institutions may face difficulties assessing credit risk due to limited access to borrower financial data, COVID-19 event-induced covenant breaches, and difficulty analyzing the impact of COVID event-related government assistance programs." The key to the August 3 joint statement is that it more completely defines what banking regulators consider to be prudent four months after banks were originally encouraged to grant loan accommodations in accordance with Section 4013 of the CARES Act and the April 7 interagency statement.

The August 3 joint statement advised banks to follow five risk management and consumer protection principles in order to perform the "prudent" practices necessary for providing additional loan accommodations to borrowers whose loans are near or at the end of initial accommodation periods. These principles are (i) the implementation of prudent risk management practices; (ii) the use of well-structured and sustainable accommodations; (iii) respect for required consumer protections; (iv) the observance of applicable GAAP and regulatory reporting requirements; and (v) the establishment of internal control systems for quality assurance, credit risk review, operational risk management, compliance risk management, and internal audit functions.

With respect to prudent risk management practices, the August 3 joint statement stated that such practices include "identifying, measuring, and monitoring the credit risks of loans that receive accommodations" so that the bank can "accurately monitor the terms of accommodations (such as payment changes, interest rate changes, and modified amortization terms)" and can "recognize any deteriorations, including potential loss exposure, in a timely manner." The August 3 joint statement says that such practices include "applying appropriate loan risk ratings or grades and making appropriate accrual status decisions on loans affected by the COVID event," and it suggests that "following an accommodation, a financial institution reassess risk ratings for each loan based on a borrower's current debt level, current financial condition, repayment ability, and collateral."

As for observing applicable GAAP and regulatory accounting and reporting guidance, the August 3 joint statement stated that banks will be required to maintain appropriate allowances for loan and lease losses or allowances for credit losses, and that in doing so, they should consider all relevant and available information when assessing the collectability of cash flows, including changes in borrower financial condition, collateral values, lending practices, and economic conditions resulting from the COVID-19 pandemic. The August 3 joint statement added that according to GAAP, loans are to be segmented into a separate portfolio for the purposes of estimated credit losses when they share similar risk characteristics, implying that loans receiving COVID-19 modifications should be analyzed separately for that purpose. It also said that banks should continue to refer to the applicable regulatory reporting instructions when determining whether a modified loan should be reported as a

nonaccrual asset, which generally is required when payment in full of principal or interest is not expected.

Therefore, contrary to initial impressions, the August 3 joint statement makes it clear that banks may be expected to more closely analyze loans receiving COVID-19 accommodations and, as a result of that analysis, may be expected to classify a loan, identify it as impaired, create an appropriate credit allowance for it, or (in certain circumstances) put it on nonaccrual status. This seems like an almost 180-degree change from FIL-17-2020, wherein the FDIC said that a bank's prudent efforts to modify the terms of existing loans for affected customers would not be subject to examiner criticism, as well as from the April 7 interagency statement, wherein regulators said that COVID-19 modified loans should generally not be reported as past due, nonaccrual, or charged off unless more information becomes available that indicates a specific loan will not be repaid.

That said, this apparent reversal does more closely resemble the definition of "prudent," and a bank's observance of these heightened expectations in its next round of COVID-19 loan accommodations may not only prevent problems during their next safety and soundness exam, but may also prevent a "crash landing" of the bank's loan portfolio. Banking policy and regulatory guidance have been far from clear during this pandemic, a fact that was reiterated again on September 4 when the Centers for Disease Control (CDC) and Prevention issued its eviction moratorium, making it even harder for banks to evaluate the health of their commercial real estate borrowers that may not be receiving rent from residential lessees they can't evict for the remainder of the year. Meanwhile, what is becoming all too clear — and the subject of broad consensus — is that we are only beginning to see the credit problems created by this pandemic, regardless of how long the health event lasts. Therefore, the quicker banks can regain their flight control monitors while they find a way through the COVID-19 storm, the less likely they are to experience a crash landing of their loan portfolio before the storm has passed.

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